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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	)	
	)	
Price Cap Regulation of	)	
Local Exchange Carriers	)	CC Docket No. 93-179
	)	
Rate of Return Sharing	)	
And Lower Formula Adjustment	)	

REPLY COMMENTS

U S WEST Communications, Inc. (or "U S WEST"), through counsel, and pursuant to the Federal Communications Commission's ("Commission") Notice of Proposed Rulemaking,[1] hereby files its reply to comments on the Commission's "add-back" proposal.

I. INTRODUCTION

Thirteen parties, representing both local exchange company ("LEC") and interexchange company interests, filed comments on the Commission's "add-back" proposal.[2] LECs, with the exception of NYNEX and SNET, were adamant in their opposition to virtually

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[1] In the Matter of Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment, Notice of Proposed Rulemaking, 8 FCC Rcd. 4415 (1993) ("NPRM").

[2] Comments were filed herein July 30, 1993 and Aug. 2, 1993, by American Telephone and Telegraph Company ("AT&T"), Ameritech Operating Companies ("Ameritech"), The Bell Atlantic Telephone Companies ("Bell Atlantic"), BellSouth Telecommunications, Inc. ("BellSouth"), GTE Service Corporation ("GTE"), MCI Telecommunications Corporation, Inc. ("MCI"), NYNEX Telephone Companies ("NYNEX"), Pacific Bell and Nevada Bell ("Pacific Companies"), Rochester Telephone Corporation ("Rochester"), Southern New England Telephone Company ("SNET"), Southwestern Bell Telephone Company ("SWB"), U S WEST Communications, Inc., and United States Telephone Association ("USTA").

all aspects of the Commission's proposal. LECs argued that the Commission's "add-back" proposal: 1) was a substantive change in the price cap rules rather than a clarification;[3] 2) could not be applied retroactively, if adopted;[4] 3) should be considered in the 1994 price cap review rather than adopted on the eve of the review;[5] 4) was defective in that it equated "sharing under price cap regulation" to "refunds under rate of return regulation;"[6] 5) would violate the intent of the price cap order to limit sharing and low-end adjustments to a single year;[7] 6) would distort incentives under price cap regulation and introduce inefficiencies;[8] and 7) should include a credit for below-cap rates, if adopted.[9]

NYNEX and SNET, beneficiaries of low-end adjustments, took a position 180° different from other LECs. They argue that: 1) the Commission's proposal was a clarification of existing rules;[10] 2) the price cap system would be legally invalid

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[3] See BellSouth at 2; Pacific Companies at 3; U S WEST at 5-6.

[4] See U S WEST at 5; BellSouth at 3.

[5] See BellSouth at 2; GTE at 14-15; Pacific Companies at 3; Rochester at 4; SWB at 1; U S WEST at 9; USTA at 4-5.

[6] U S WEST at 3-5; see also Ameritech at 2; Bell Atlantic at 5; Pacific Companies at 2.

[7] See Ameritech at 6; Bell Atlantic at 2-3; U S WEST at 3.

[8] See Ameritech at 9; Bell Atlantic at 4; Pacific Companies at 2-3.

[9] See Bell Atlantic at 7; BellSouth at 9-10; Ameritech at 7.

[10] NYNEX at 2.

without normalization (i.e., "add-back");[11] 3) there would be artificial swings in earnings without "add-back;"[12] and 4) the Commission should not adopt a credit for below-cap rates.[13] In supporting the Commission's proposal, "to prescribe 'add-back' treatment of the LECs' past backstop amounts," AT&T argues that sharing should be treated in the same manner as refunds under rate of return regulation in order to ensure uniform treatment of LEC earnings.[14] MCI supports "adding back" sharing amounts but vehemently opposes "adding back" low-end adjustments.[15]

Proponents of "add-back" provide no plausible arguments which would support a finding that the Commission's "add-back" proposal is a clarification of existing rules. Furthermore, proponents offer no compelling arguments why the Commission should adopt a significant modification in its price cap rules on the eve of the LEC price cap review.[16]

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[11] Id. at 5-7.

[12] See SNET at 3.

[13] See NYNEX at 12-13.

[14] AT&T at 4-5. AT&T makes the incongruous claim that the Commission can "prescribe add-back" in its current investigation of Annual Access Tariffs even though AT&T recognizes that "the instant rulemaking is solely prospective, and thus would not apply to the access rates currently under investigation by the Commission." Id. at 6.

[15] MCI at 1-2. MCI attempts to justify its position by distinguishing sharing from low-end adjustments. MCI equates sharing amounts to pre-price cap refunds and low-end adjustments to pre-price cap rate increases. Id. at 11.

[16] NYNEX's arguments appear to be based on the premise that an individual LEC has no control over its earnings and cannot operate in an economically efficient manner. In addition to

(continued...)

II. COMMENTS PROVIDE NO SUPPORT FOR THE ASSERTION THAT THE COMMISSION'S "ADD-BACK" PROPOSAL IS A CLARIFICATION OF EXISTING RULES

U S WEST and numerous other commentors argued strenuously that the Commission's "add-back" proposal is a substantive rule change -- not a clarification of existing rules.[17] Even AT&T, a supporter of the Commission's "add-back" proposal, explicitly recognizes that the "instant rulemaking is solely prospective."[18] Only NYNEX claims that the Commission's proposal is a clarification rather than a substantive rule change.[19] NYNEX attempts to support this view by asserting that the price cap system would be "legally invalid" without a requirement to "add-back."[20] NYNEX cites the Court's decision in AT&T v. FCC[21] on the automatic refund rules as precedent for this assertion. Clearly, AT&T v. FCC is inapposite; it provides no support for NYNEX's price cap arguments. NYNEX is attempting

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[16](...continued)
being ridiculous, this assumption is totally at odds with the concept of incentive-based regulation which is the basis of the Commission's price cap plan.

[17]Note 3 supra.

[18]AT&T at 6.

[19]NYNEX at 8-9.

[20]Id. at 3.

[21]American Tel. and Tel. Co. v. FCC, 836 F.2d 1386 (D.C. Cir. 1988) ("AT&T v. FCC"), reh'g denied, Orders, Nov. 2, 1988 and Nov. 23, 1988 (No. 85-1778).

to turn price regulation "on its head" with such specious arguments.[22]

In AT&T v. FCC the Court found that the Commission's automatic refund rules deprived LECs of an opportunity to earn the minimum cost of capital.[23] The Commission's rules were based on a rate of return system of regulation which did not allow LECs to make-up earning shortfalls in any given category (i.e., less than the minimum necessary to attract capital) but found rates even marginally above the authorized return to be unlawful. Thus, under the Commission's automatic refund rules, it would be all but impossible for a LEC to earn the authorized minimum rate of return on its total rate base over any period of time.[24]

Price cap regulation is entirely different -- the only similarity is that earnings, measured in terms of rate of return, are used to trigger low-end and sharing adjustments. NYNEX is "grasping at straws" in using such arguments to claim that "add-back" is essential to maintain the integrity of price cap regulation.[25] This is not even a plausible argument. The

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[22]Ameritech correctly points out that the Commission adopted price cap regulation as "a substitute for rate of return regulation" and that sharing was never intended to be the equivalent of a refund under rate of return regulation. Ameritech at 2-3. NYNEX's arguments ignore these points and assume that price cap LECs are still subject to traditional rate of return regulation.

[23]AT&T v. FCC, 836 F.2d at 1390.

[24]Id. at 1390-91.

[25]NYNEX at 3.

Commission did not mention "add-back" or normalization in its price cap orders. The issues of sharing and low-end adjustments were topics of much controversy in the price cap proceeding and were extensively briefed. If the Commission had adopted an "add-back" or normalization requirement as part of LEC price cap regulation, everyone would have known about it.

As BellSouth points out in its comments, the Court's decision on the treatment of promotional rates under the AT&T price cap plan[26] provides no support for the assertion that the Commission's "add-back" proposal is a "clarification."[27] In fact, it leads to just the opposite conclusion -- that the Commission's "add-back" proposal is a substantive rule change which can only be applied prospectively if adopted. The Commission should abandon the notion that its "add-back" proposal is a clarification of existing rules and recognize that the product of this rulemaking proceeding can only be a new substantive rule.[28]

III. FAILURE TO PROVIDE FOR A CREDIT FOR BELOW CAP RATES WOULD DISTORT LEC INCENTIVES AND HARM THE PUBLIC INTEREST

If the Commission modifies its price cap rules to include an "add-back" requirement, it must also include a credit for LECs'

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[26] American Tel. & Tel. v. FCC, 974 F.2d 1351 (D.C. Cir. 1992).

[27] BellSouth at 7.

[28] The Commission should also recognize that such a substantive change in the Commission's rules would require more than just a modification in the definition of the term "base year." See id. at 2.

price cap indices ("PCI").[29] Otherwise, LECs will be penalized for pricing below their caps. Such a result would be totally at odds with the incentive-based principles which underlie price cap regulation and would harm the public interest. The public interest would not be served by a regulatory structure which encourages LECs to establish the highest possible rates (i.e., at their PCI). If the Commission adopts its "add-back" proposal, it should also adopt Ameritech's proposal for calculating the "add-back" amount.[30] Ameritech's proposal appropriately excludes interest from "add-back" amounts.[31]

IV. IF THE COMMISSION PROCEEDS FORWARD WITH THE INSTANT RULEMAKING, IT SHOULD ALSO CORRECT THE PROBLEM ASSOCIATED WITH THE SELECTION OF A 4.3 PERCENT PRODUCTIVITY FACTOR

BellSouth urges the Commission to eliminate the penalty associated with the selection of a 4.3 percent productivity factor if it proceeds with the instant rulemaking on price cap regulation.[32] U S WEST supports BellSouth's recommendation. The current price cap rules require a permanent reduction in a LEC's PCI when it selects a 4.3 percent productivity factor even though the additional sharing benefits only last for one year.

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[29] Id. at 9-10; Ameritech at 7-9; Bell Atlantic at 7.

[30] See Ameritech at 8-9.

[31] Id. at 7. Ameritech correctly points out that "Ratepayers have already received the benefit of the interest amount during the period when the sharing adjustment was in effect. If the interest amount is included in the add back amount, portions of this interest amount would be given back again in future sharing periods." Id.

[32] BellSouth at 11-12.

This makes no sense and discourages LECs from selecting a higher productivity factor. A change in this aspect of the price cap rules would serve the public interest by more properly aligning the risks and rewards associated with selecting a higher productivity offset.

V. CONCLUSION

The Commission should refrain from taking any action on its "add-back" proposal at this time. If the Commission continues to believe that its "add-back" proposal is the appropriate course of action after examination of comments in this proceeding, it should include "add-back" in its comprehensive review of price cap regulation in 1994 along with other issues such as the 4.3 percent productivity offset discussed above. No purpose would be served in trying to retroactively apply the "add-back" proposal or to adopt it prospectively at this late date in the initial price cap review period.

The comments provide little, if any, support for the view that the "add-back" proposal is a "clarification," rather than a substantive rule change. The comments do highlight the fact that the effects of adopting the "add-back" proposal will be much broader and more perverse than anticipated by the NPRM. As such,

the Commission should conclude that "add-back" is inconsistent with price cap regulation and terminate the instant rulemaking.

Respectfully submitted,

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September 1, 1993

CERTIFICATE OF SERVICE

I, Roanne Kuenzler, do hereby certify that on this 1st day of September, 1993, I have caused a copy of the foregoing **REPLY COMMENTS** to be served via first-class United States Mail, postage prepaid, upon the persons listed on the attached service list.

Roanne Kuenzler

***Via Hand-Delivery**

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